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SUBJECT: Assessment Procedures – Wage Discrepancy

QUESTION PRESENTED

Does the Franchise Tax Board (FTB) have the authority to issue a summary assessment¹ under Revenue and Taxation Code section 19051, instead of a statutory notice of proposed deficiency under Revenue and Taxation Code section 19033, where the taxpayer reports wage income on a tax return that is less than that shown on the taxpayer's Form W-2?

CONCLUSION

In the circumstances contemplated here, FTB does not have the authority to issue a summary assessment under Revenue and Taxation Code section 19051 because it is not discernable whether the error was made by the taxpayer in reporting wages on the tax return or whether the error actually occurred on the Form W-2 and because the assessment of tax is disputable.

ANALYSIS AND DISCUSSION

FTB's Information Validation Section is responsible for the processing of tax returns which includes, among other things, verifying the accuracy of tax return information and correcting math errors on tax returns. Under certain conditions, such as when a taxpayer makes a

¹ For purposes of this memorandum, the term "summary assessment" refers to an assessment resulting from a mathematical error on a tax return, pursuant to Revenue and Taxation Code section 19051, notice of which is typically made on a Return Information Notice. The "summary assessment" procedures do not provide the taxpayer with protest or appeal rights, which is unlike the normal deficiency assessment procedures.

mathematical error on a tax return that results in an increase in tax, FTB may issue a summary assessment under Revenue and Taxation Code section 19051. The resolution of cases under the normal deficiency assessment procedures² is significantly more costly in terms of personnel, processing and delays in collection of taxes than the resolution of cases under the summary assessment procedures. As such, considering the cost effectiveness of the summary assessment procedures, it is more desirable to follow those procedures.

Current procedures in the Information Validation Section provide for the issuance of a summary assessment notice, under Revenue and Taxation Code section 19051, in circumstances where the taxpayer reports wage income on a tax return that is less than that shown on the taxpayer's Form W-2. Under current procedures, taxpayers could object to the summary assessment notice (Return Information Notice) and FTB would provide the taxpayer with an informal dispute process, without the need to prepay the amount disputed. For example, the taxpayer could contact FTB's Taxpayer's Service Center Section, object to the Return Information Notice and provide evidence to the customer service representative that the error causing the wage discrepancy actually occurred on the Form W-2.

However, the Internal Revenue Service recently issued Revenue Ruling 2005-51 which advises that the summary assessment procedures should not be followed in circumstances where the taxpayer reports wage income on a tax return that is less than that shown on the taxpayer's Form W-2. In light of Revenue Ruling 2005-51, the Information Validation Section requested advice concerning the legality of issuing a summary assessment in the circumstances contemplated here.

Revenue Ruling 2005-51 clearly indicates that any tax which results from a wage income discrepancy may not be assessed under the summary assessment procedures; rather it has to be assessed by the normal deficiency assessment procedures. In Revenue Ruling 2005-51, the IRS reasoned:

The Tax Reform Act of 1976, Pub. L. No. 94-455, § 1206, 90 Stat. 1520 (1976) (the Act), clarified the situations in which the Secretary may use the summary assessment authority of section 6213(b) for mathematical or clerical errors arising from inconsistencies. The legislative history of the Act states that the exception for inconsistent entries applies only “where it is apparent which of the inconsistent entries is correct and which is incorrect.” S. Rep. No. 938, 94th Cong., 2d Sess., 376 (1976), 1976-3 (Vol. 3) C.B. 49, 414.

The IRS ruled in Revenue Ruling 2005-51 that where it is not apparent whether the amount reported by the taxpayer on the face of the return or the amount on the Form W-2 is correct, the formal deficiency assessment procedures must be followed.

² Taxpayers obtain the right to protest and appeal deficiency assessments under Revenue and Taxation Code sections 19041 and 19045, respectively. Those sections provide the taxpayer with the right to dispute the deficiency without first requiring payment of the deficiency.

Furthermore, FTB's Legal Division previously drafted Technical Advice Memorandum (TAM) 97-0159 that addressed this same subject matter. In that TAM, the Legal Division advised that the summary assessment procedures should not be followed under the circumstances contemplated here. In TAM 97-0159, it was determined that adjustments to payments or withholding are distinguishable from "changes to income that result in an increase in tax liability, (rebate refunds) which are generally treated as deficiency assessments that require pre-collection protest and appeal rights." TAM 97-0159 also illustrates the legislature's practice of providing FTB with distinctive statutory authority to issue a summary assessment for taxes that result from changes to tax returns that are not "math error" corrections. TAM 97-0159 indicates that two bills pending before the legislature, in 1997, expressly provided for summary assessment procedures in those circumstances where there is a wage income discrepancy. These bills were never enacted.

Despite the Legislature's determination not to enact that bill and the advice in TAM 97-0159, FTB apparently made a policy decision that the summary assessment procedures could be followed for wage discrepancies.

Moreover, FTB's Legal Division previously drafted TAM 2004-53 which discussed the appropriateness of the summary assessment procedures under another situation. The issue raised in TAM 2004-53 was whether FTB had the authority to issue a summary assessment if any entity that has not established that it qualifies for tax-exempt status files an exempt organization return. The primary focus in that TAM was on the definition of a "mathematical error" because the summary assessment procedures are permitted by statute if the assessment of tax can be described as an assessment of tax due to a mathematical error. In arriving at a definition of a "mathematical error," the advice in TAM 2004-53 relied on the IRS's General Counsel Memorandums which provided case law³ to support its definition. In those memorandums, a "math error" was defined as an error appearing on the face of the return where there can be no real dispute. It was concluded in TAM 2004-53 that FTB does not have the authority to issue a summary assessment under Revenue and Taxation Code section 19051 because the "error" in filing an exempt organization return is not discernable from the face of the return and the assessment of tax is disputable.

Accordingly, in making a determination as to whether a summary assessment is permissible where there is a wage discrepancy, the same definition of a "math error" in TAM 2004-53 should be applied.

First, is the discrepancy in wages an error that is evident on the face of the tax return? The answer is no. The discrepancy in wages would be evident by reviewing the wage income entries on the tax return and comparing it to the entries on the Form W-2. However, it is unclear whether the actual error is an overstatement of income on the Form W-2 or the taxpayer's error in understating the income on the tax return. In other words, it is not readily discernable on the face of the tax return whether there is an error by the taxpayer in reporting wages or whether the error in the wage discrepancy actually occurred on the Form W-2. This same analysis is consistent with the IRS's recent Revenue Ruling 2005-51 wherein the legislative history of the Tax Reform

³ *Repetti v. Jamison* (N.D. Cal. 1955) 131 F. Supp. 626, aff'd. (9th Cir. 1956) 239 F.2d 901; *Farley v. Scanlon* (E.D. N.Y. 1964) 13 AFTR 2d 932.

Act of 1976 provides that an exception for issuing a summary assessment based on inconsistent entries applies "only where it is apparent which one of the inconsistent entries is correct and which is incorrect." Therefore, the wage discrepancy cannot be defined as a "mathematical error" because one cannot readily discern whether the error occurs on the tax return or the Form W-2.

Secondly, is the wage discrepancy disputable? Absolutely. It is quite conceivable that the amount of wages shown on a Form W-2 is incorrect. However, as indicated above, it is not readily discernable on the face of the tax return whether the error in the wage discrepancy was made by the taxpayer or whether the error actually occurred on the Form W-2. In the circumstances contemplated here, it is clear that a discrepancy in wages is a disputable item and the taxpayer should be afforded the fundamental right of "due process," where the taxpayer is allowed the right to dispute an assessment without having to make prepayment. However, the summary assessment procedures under Revenue and Taxation Code section 19051 do not provide for due process because the taxpayer has no right of protest or appeal based on the Return Information Notice. Further, in the IRS's General Counsel Memorandums, the summary assessment procedures were applied very conservatively to the specific circumstances in the requests for legal advice. The memorandums state, "We should be very careful in extending the definition of a mathematical error from that described in the court decisions . . . , since the affect thereof would be a circumvention of the specifically prescribed deficiency procedures." That same cautious approach to applying Revenue and Taxation Code section 19051 should also be followed here. The more formal deficiency assessment procedures set forth under Revenue and Taxation Code sections 19041 and 19045 should be followed in the circumstances contemplated here to allow the taxpayer his/her right of "due process." Therefore, the circumstances contemplated here cannot be defined as a "mathematical error" because the discrepancy in wages is disputable.

Finally, in other non-math error situations such as this one, the Legislature has deemed it necessary to provide FTB with separate statutory authority to issue a summary assessment in the same manner as provided for by Revenue and Taxation Code section 19051. For example, Revenue and Taxation Code section 19054 provides FTB with the authority to issue summary assessments, in the same manner as prescribed by Revenue and Taxation Code section 19051, where there is an overstatement of a withholding credit or estimated tax payment. (See also Revenue and Taxation Code sections 19043.5 and 17053.8.) As evidenced by these statutes, the Legislature has provided a specific summary remedy for errors, other than mathematical errors, where the errors did not justify the expense of an audit or the normal deficiency procedures under Revenue and Taxation Code sections 19041 and 19045. As such, FTB should be very cautious in utilizing summary assessment procedures unless statutory authority exists which specifically sets forth the circumstances under which the summary assessment may be made.

Consistent with TAM 97-0159, TAM 2004-53, the General Counsel Memorandums cited in TAM 2004-53, and Revenue Ruling 2005-51, the summary assessment procedures should not be followed under the circumstances presented here.

In conclusion, the FTB does not have the authority to issue a summary assessment under Revenue and Taxation Code section 19051 based on the circumstances contemplated here

because the wage discrepancy cannot be defined as a "math error." In order to circumvent the normal deficiency procedures, a specific statute authorizing a summary assessment under the circumstances contemplated here would have to be enacted.

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